DEPARTMENT OF STATE REVENUE

04-20091041.LOF

Letter of Findings: 09-1041
Gross Retail Tax
For the Years 2006, 2007, and 2008

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ISSUES

I. Test Cell Equipment – Gross Retail Tax.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-4-1; IC § 6-2.5-4-2; IC § 6-2.5-5-3(b); IC § 6-2.5-5-40; IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Indianapolis Fruit v. Dept. of State Revenue 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Sales Tax Information Bulletin 75 (October 2008); Sales Tax Information Bulletin 75 (September 2007).

Taxpayer argues that it is not subject to sales or use tax on the equipment found in its test cells.

II. Aircraft Rental – Gross Retail Tax.

Authority: IC § 6-2.5-4-10; IC § 6-2.5-4-10(b); IC § 6-2.5-5-8(b).

Taxpayer maintains that it was not required to pay sales tax on payments made to rent an aircraft on the ground that sales tax was paid on the original purchase price of the aircraft.

III. Electrical Generator – Gross Retail Tax.

Authority: IC § 6-8.1-5-1(c); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer states that is was not required to pay sales tax on the purchase of a generator because the generator is used, in part, to serve as a backup power source for activities conducted within its test cells.

IV. Fuel Purchases – Gross Retail Tax.

Authority: IC § 6-2.5-5-8(b); IC § 6-8.1-5-1(c).

Taxpayer maintains that it was not required to pay sales tax or self-assess use tax when it acquired fuel arguing that the fuel was resold to its customers.

V. Ten-Percent Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer asks that the Department exercise its authority to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation which elected "S Corporation" status. Taxpayer provides manufacturing, testing, and research and development services. Taxpayer sells its services to government and private entities.

The Department of Revenue (Department) conducted an audit review of Taxpayer's business records and tax returns. As a result of that audit, the Department determined that Taxpayer owed additional sales/use tax. Taxpayer disagreed with a portion of that assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives further explained the basis for its protest. This Letter of Findings results.

I. Test Cell Equipment – Gross Retail Tax.

DISCUSSION

Taxpayer operates a number of test cells. The test cells contain testing equipment. Taxpayer earns money from leasing the test cells. The Department's audit concluded that Taxpayer owed use tax on "71.50 [percent] of total purchase under the manufacturing labeled items." These items were purchased for use in the test cells.

Taxpayer argues that the items are not subject to use tax because the items fall under either – or both – the "manufacturing" and the "research and development" exemptions.

Pursuant to IC § 6-2.5-2-1, a sales tax, known as state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Retail transactions generally involve the transfer of tangible personal property. IC § 6-2.5-4-1. A complementary excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction. IC § 6-2.5-3-2.

A. Manufacturing Exemption:

In this instance, Taxpayer invokes two exemptions; one of the exemptions is found at IC § 6-2.5-5-3(b). The exemption statute reads as follows:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture,

fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (Emphasis added).

As a threshold issue, it is Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). IC § 6-2.5-5-3(b) like all tax exemption provisions, is strictly construed against exemption from the tax. Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

Taxpayer provided a number of examples of the activities which occur within the test cells.

[Taxpayer] received a current product engine from a client that was designed and produced to meet U.S. emissions regulations. [Taxpayer] was engaged to take this engine and custom manufacture a new engine that would meet the performance and emissions requirements for [a particular industrial] market. [Taxpayer] had to substantially change the existing engine configuration by removing the exhaust after-treatment system from the engine and make substantial changes to the entire computer algorithm. [Taxpayer] physically removed the after-treatment system from the engine and fabricated a new integral exhaust system. [Taxpayer] machined adapters to make the new exhaust system, welded components into the system, and assembled it onto the engine. Adjustments were made to the new hardware until the engine ran efficiently. Then [Taxpayer] began engine control module changes to reduce the exhaust emissions. Changes include engine timing, fueling and the fine turning of the exhaust gas recirculation system in complex combinations.... At the conclusion of this project, the client will receive the newly manufactured engine and after treatment system that now meets the emissions requirements for [the particular industrial market].

A second example follows:

[Taxpayer] is engaged to manufacture a [fuel] exhaust system; specifically, a [] particulate filter package. [Taxpayer] must construct a filter which optimizes the filter/engine combination for compatibility. To do this, [Taxpayer] begins with a raw material substrate which [Taxpayer] fabricates to withstand high temperatures and resist corrosion, without hindering the performance properties of the substrate material. [Taxpayer] continues the process on the engine by assembling the appropriate combination of engine, after treatment components, and exhaust paths with the [] particulate filter. [Taxpayer] must then test the integrity of the parts produced. Results can repeatedly send [Taxpayer] back to the fabrication shop for modifications or a new build. Upon completion of a successful container build, [Taxpayer] produces the elements to complete the particular combination. The next steps include building a set of arrays within the engine control module, machining and assembling injectors for system regeneration, and creating a framework for the collective to interact. At the end of this manufacturing process, [Taxpayer] will deliver a complete engine system with an integrated exhaust after treatment component and controls that were made at [Taxpayer].

A third and final example follows:

[Taxpayer] is engaged to manufacture engine components that will withstand elevated temperatures and rapid temperature changes, subject to specifications provided by the customer. At the end of the project [Taxpayer] will provide a complete engine outfitted with specialty parts that have been manufactured by [Taxpayer] to endure the extreme temperature changes, along with documentation of [Taxpayer's] test to evidence that [Taxpayer] manufactured components withstood the specified temperature tests.

Above are instances in which Taxpayer utilized its "test cells" to develop engines or engine components. In support of its protest, Taxpayer produced other instances each of which describe the development of an engine component, such as fuel injection or exhaust system, or the development of an engine designed to meet certain specified criteria. For example, Taxpayer might be required to develop an engine which operates at high altitudes, functions in extreme temperatures, or which uses an alternative fuel.

IC § 6-2.5-4-2 distinguishes "manufacturing" from "industrial processing" stating as follows:

(c) Notwithstanding any provision of this article, a person is not making a retail transaction when he: (1) acquires tangible personal property owned by another person; (2) provides industrial processing or servicing, including enameling or plating, on the property; and (3) transfers the property back to the owner to be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in his business of manufacturing, assembling, constructing, refining, or processing.

The Department's audit did not entirely disagree with Taxpayer's contention that it was engaged in "manufacturing." As stated in the report, "The Taxpayer and the Department have agreed that this category [Manufacturing] is exempt from use tax under the Code 45 IAC 2.2-5-8." However the report noted that, "The Department considers the term manufacturing for this taxpayer, not as the traditional manufacturing but as 'engineering services and test cells'. The services provided to the taxpayer's customers in this category include test cell use." In effect, the audit removed from the "manufacturing" category items related to the test cells. As explained, "Due to the fact that direct manufacturing items were included in this category, the audit is assessing

on 71.50 [percent] of total purchases under the manufacturing labeled items."

The issue is whether the activities contained within the test cells constitute "manufacturing" or not. The audit found that equipment contained within the test cells were not used for manufacturing. As stated in the report, "[T]he Department considers the term manufacturing, for this taxpayer, not as traditional manufacturing, but as 'engineering services and test cells.'" In this instance, the Department agrees with the audit's characterization. Taxpayer is not engaged in a traditional – or even "non-traditional" manufacturing activity. Various engine manufacturers hire taxpayer to research and develop prototype engines which meet specific design and performance criteria. The result of that research and development is a prototype engine which meets those criteria but that prototype engine is not a "marketable good." As explained by the Tax Court, "In the context of the exemption provision at issue [IC § 6-2.5-5-3], production is 'defined broadly' and 'focuses on the creation of a marketable good.'" Indianapolis Fruit v. Dept. of State Revenue 691 N.E.2d 1379, 1383 (Ind. Tax Ct. 1998). See also Mech. Laund. & Supply v. Dept. of Revenue 650 N.E.2d 1223, 1228 (Ind. Tax. Ct. 1995) ("Without the production of goods or, to use the language of the statute, 'other tangible personal property,' the equipment exemption does not apply.")

B. Research and Development:

Alternatively, Taxpayer argues it is entitled to the research and development exemption set out in IC § 6-2.5-5-40. That exemption provides a sales tax exemption "for research and development equipment purchased after June 30, 2007." Sales Tax Information Bulletin 75 (October 2008); (20081029-IR-045080815 NRA). That exemption states as follows:

(a) As used in this chapter, "research and development activities" does not include any of the following:
(1) Efficiency surveys.
(2) Management studies.
(3) Consumer surveys.
(4) Economic surveys.
(5) Advertising or promotions.
(6) Research in connection with literary, historical, or similar projects.
(7) Testing for purposes of quality control.

(b) As used in this section, "research and development equipment" means tangible personal property that:
(1) consists of or is a combination of:
(A) laboratory equipment;
(B) computers;
(C) computer software;
(D) telecommunications equipment; or
(E) testing equipment;
(2) has not previously been used in Indiana for any purpose; and
(3) is acquired by the purchaser for the purpose of research and development activities devoted directly to experimental or laboratory research and development for:
(A) new products;
(B) new uses of existing products; or
(C) improving or testing existing products.

(c) A retail transaction:
(1) involving research and development equipment; and
(2) occurring after June 30, 2007; is exempt from the state gross retail tax.

However, Taxpayer's quarrel is with the audit's conclusion that Taxpayer "isn't entitled to the R & D exemption if the equipment has a useful life of less than one year." The Department's position is set out at Sales Tax Information Bulletin 75 (October 2008) which states:

> Research and development equipment means tangible personal property that consists of laboratory equipment, computers, computer software, telecommunications equipment, or testing equipment that has not previously been used in Indiana for any purpose and is acquired by the purchaser and devoted directly to experimental or laboratory research and development for new products, new uses of existing products, or improving or testing existing products. Research and development equipment does not include hand powered tools or property with a useful life of less than one year. (See also Sales Tax Information Bulletin 75 (September 2008) (20071003-IR-045070635 NRA)).

The rules of statutory construction require that exemption statutes be strictly construed against the Taxpayer. Indiana Dep't of State Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

In this situation, the audit applied the Department's policy as stated in Sales Tax Information Bulletin 75 (October 2008) and denied certain items because they were materials that had a useful life of less than one year and were "expensed." The Taxpayer argued that the statute concerning the research and development exemption did not differentiate between capitalized purchases and expensed purchases. The statute, however, sets out five groups of durable equipment that would be capitalized as research and development equipment exempt from the sales tax. The protested items are not durable property such as computers, software programs, laboratory

equipment, telecommunications equipment, and testing equipment that will last over one year and be capitalized. The legislature did not see fit to include a category for materials that would be consumed within a year and were "expensed." Since exemption statutes are strictly construed against the Taxpayer requesting the exemption, the Department is unable to expand the statutory definition of equipment to be used in research and development to include materials to be used and consumed in research and development. Therefore, the protested items do not qualify for the research and development sales tax exemption pursuant to IC § 6-2.5-5-40.

FINDING

Taxpayer's protest is respectfully denied.

II. Aircraft Rental – Gross Retail Tax.

DISCUSSION

Taxpayer argues that the Department improperly assessed use tax on the price Taxpayer paid to rent an aircraft.

IC § 6-2.5-4-10 provides for the imposition of sales tax on money received from the rental of tangible personal property. In part, the statute provides:

> (a) A person, other than a public utility, is a retail merchant making a retail transaction when he rents or leases tangible personal property to another person other than for subrent or sublease. (b) A person is a retail merchant making a retail transaction when the person sells any tangible personal property which has been rented or leased in the regular course of the person's rental or leasing business.

Taxpayer argues that the imposition of the sales tax was inappropriate because the aircraft is owned by a disregarded entity which is owned by an individual who is the husband of Taxpayer's owner. Taxpayer indicates that the disregarded entity paid sales tax on the purchase price of the aircraft and the "Department shouldn't impose sales tax a second time on leasing to self...."

Taxpayer raises an interesting point; it is entirely possible that the disregarded entity's purchase of the aircraft should have been exempt because disregarded entity may be in the business of renting or leasing the aircraft "in the course of the [disregarded entity's] business...." See IC § 6-2.5-5-8(b). However that exemption is not at issue here. The question is whether or not the audit correctly assessed sales/use tax on the stream of rental income derived from the rental of the aircraft. Based on the information presented, the answer to that question is "yes." Under IC § 6-2.5-4-10(b), Taxpayer entered into a retail transaction whereby it rented an aircraft.

FINDING

Taxpayer's protest is respectfully denied.

III. Electrical Generator – Gross Retail Tax.

DISCUSSION

The Department's audit assessed use tax on the price paid for an electrical generator. Taxpayer indicates that it intends to use the generator for multiple purposes. Taxpayer indicates that the generator has a "potential use in test cells" but would also be available as a backup power source about ten hours each year.

As explained by Taxpayer, "[T]he audit denied the Industrial Exemption and R & D Exemption on a generator purchased by [Taxpayer] for use in the test cells because the generator would also be available as a contingent back up generator for future data storage." Taxpayer further explains that "[T]axpayer would expect [the generator] to be used as a backup power source about 10 hours per year, whereas its potential use in test cells is projected to be one hundred hours in use as a backup power source." Taxpayer believes that one or the other exemptions should be applicable based on the "intent at the time of purchase, with adjustments later if the actual use deviates from the projected use."

The issue is whether Taxpayer is entitled to claim an exemption based on Taxpayer's stated intent to use the generator in an exempt manner. As noted in Kimball cited above, "[T]ax exemptions are strictly construed in favor of taxation and against the exemption." Kimball. 520 N.E.2d at 456. Taxpayer asks the Department to speculate as to whether the generator will or will not be used in an exempt fashion, but the Department must decline the invitation to do so. Simply stated, there is insufficient information to determine how or to what extent the generator will be used. Taxpayer has not met its burden of demonstrating that the original assessment was wrong. IC § 6-8.1-5-1(c).

Taxpayer's request to determine whether or not an exemption applies to the purchase of the generator is premature.

FINDING

Taxpayer's protest is respectfully denied.

IV. Fuel Purchases – Gross Retail Tax.

DISCUSSION

The audit reviewed Taxpayer's purchases of fuel and oil and found that the "fuel/oil [was] used and consumed during 'manufacturing-direct' and 'engineering services.'" The audit also found that the "Dyed diesel fuel, jet fuel, anti-freeze, oil, and lubricants were purchased exempt from the gross retail tax." The audit concluded that it should assess use tax on these purchases because the "items were not used or consumed in the direct production or manufacturing of taxpayer's products."

Taxpayer argues that it does not owe sales or use tax because it sells the fuel and oil directly to its customers

and that it qualifies for an exemption. Taxpayer references the "sale for resale" exemption found at IC § 6-2.5-5-8(b) which states:

> Transactions involving tangible personal property other than a new motor vehicle are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business without changing the form of the property.

Subsequent to the hearing, Taxpayer's representative supplied copies of invoices in which Taxpayer billed its customers for the cost of fuel. The invoices are clear; Taxpayer sold fuel products such as "B20 Bio diesel," "Low Cetane #2" and "zero sulfur fuel" to its customers. Under IC § 6-8.1-5-1(c), Taxpayer has met its burden of demonstrating that it purchased these particular products for resale to its customers. The audit division is requested to review the invoices provided and to make whatever adjustments it deems pursuant to this Letter of Findings.

FINDING

Subject to the result of the supplemental audit review, Taxpayer's protest is sustained.

V. Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty because the penalties are "unlawful for two basic reasons." Taxpayer maintains that it was not "negligent" within the meaning of the relevant statute because it exercised "reasonable care, caution and diligence...." and because the proposed assessments were "inherently arbitrary and capricious, and contrary to law."

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...."

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

The Department believes that Taxpayer erred in determining its sales and use tax liability and disagrees with its contention that the audit's conclusions were unsupported by law. However, there is insufficient information to establish that Taxpayer's position was so egregious as to constitute "willful neglect." Based on a "case-by-case" analysis and after reviewing "the facts and circumstances of each taxpayer" the Department agrees that the ten-percent negligence penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

As set out in Part IV, Taxpayer's protest is sustained subject to the result of the supplemental audit review. Taxpayer is entitled to abatement of the ten-percent negligence penalty. In all other respects, Taxpayer's protest is respectfully denied.

Posted: 11/24/2010 by Legislative Services Agency
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